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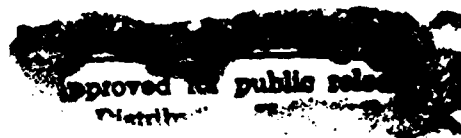
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An Assessment of China's Special Economic Zones

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ABSTRACT

AN ASSESSMENT OF CHINA'S SPECIAL ECONOMIC ZONES

This paper examines the contribution of the original four Special Economic Zones -- Shenzhen, Zhuhai, Shantou and Xiamen -- to China's economic modernization. It evaluates whether the SEZs have achieved original reform objectives, assesses the progress of the SEZs in light of original expectations, and considers possible future roles for the SEZs in China's continuing efforts to modernize its economy.

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AN ASSESSMENT OF CHINA'S SPECIAL ECONOMIC ZONES

INTRODUCTION

The Special Economic Zones (SEZs) are a highly visible component of Deng Xiaoping's economic modernization program. The original four SEZs -- Shenzhen, Zhuhai, Shantou and Xiamen -- were established in 1979 and have been a source of much discussion and inquiry ever since. This paper examines the contribution of the SEZs to China's economic modernization and evaluates whether the SEZs have achieved the following original reform objectives:

- . To use innovative market techniques to develop the coastal area of China.
- . To attract and exploit foreign investment to increase China's industrial modernization.
- . To serve as China's window to the outside world.

The first section of the paper summarizes the major economic reforms that influenced the establishment of the SEZs and currently influence the way in which SEZ performance is viewed within China. The second section assesses the progress of the SEZs in light of original expectations. The final section considers possible future roles for the SEZs in China's efforts to modernize its economy.

HISTORICAL CONTEXT OF SEZ DEVELOPMENT

The development of the Special Economic Zones is part of a very long tradition of economic reforms which began in 1949. During the last forty-four years, China has experienced approximately eight major economic reforms and many more readjustments and retrenchments. Mao Tse-tung was responsible for all of the major reforms except for one -- Deng Xiaoping's current "Four Modernizations" effort.

One of Mao Tse-tung's primary tasks as the first communist leader of China was to build an economy -- practically from scratch. Using the Soviet model as a paradigm, Mao focused on reconstituting the economy through centralized government control and planning. High priority was given to agricultural collectivization, heavy industry, and political loyalty. Small businesses, capitalist type ventures with the state, and small producers which were part of the pre-1949 economic system were virtually eliminated by 1957. State ownership and collective ownership dominated to a very great degree.¹

China's involvement in the international community was also limited. In 1949, Mao developed a policy of "leaning to the left". This policy was reflected in a reliance on Soviet aid, technical

advice and trade. The effects of China's involvement in the Korean War and deteriorating relations with the Soviet Union, amplified Mao tse-Tung's distrust of foreigners and belief in an independent, self sufficient China. Direct foreign investment from modern, industrialized countries was eventually prohibited -- total trade in 1957 was approximately 3 billion (US\$). (Total trade in 1990 was estimated at 115 billion (US\$).)

In 1958, Mao initiated the Great Leap Forward to further advance economic growth and technical development in the areas of industry and agriculture. The Great Leap Forward emphasized the importance of political ideology as a motivator for encouraging workers to greater efforts on behalf of the state. To spread the importance of political ideology, Mao decentralized many economic decisions to local Communist party faithfuls.

The economic results of the Great Leap Forward were disastrous. "China's GNP decreased by one-third in 1960. The poor harvest resulted in large-scale starvation and malnutrition. The decentralization of the economy led to the breakdown of industry, transportation, and eventually to wide-scale demoralization."² The pullout in 1961 of the Soviet Union's technicians, scientists, and financial support further weakened the economy. Mao called off the Great Leap Forward.

Five years of economic correction and adjustments to the failed policies followed the Great Leap Forward. Under Deng Xiaoping's direction, social order was restored and improvements

were made in national output.

Mao tried to stimulate greater efforts toward economic growth during the 1966-1976 Cultural Revolution. The goal of the Cultural Revolution was to wrest control of the country from the political and cultural elite and give control back to the "people." Events during the Cultural Revolution destroyed people's faith in the government's ability to lead; decimated the economy; and created civil unrest.

During the late 60's in response to increased Soviet militarism, China began to explore the possibility of a tactical alliance with the United States as a way of counteracting any further aggressive moves from the Soviet Union. The Chinese overtures fit neatly into the U.S./China policy of detente with the result that President Richard Nixon and Secretary of State Henry Kissinger met with Chinese officials in 1972. The U.S. signed a bilateral trade agreement with China -- thus ending the complete embargo that the U.S. had placed on China since 1950 during the Korean War.

Mao's death in 1976, the death of Zhou Enlai and the imprisonment of the Gang of Four, were catalysts for an internal review of past economic policy. Despite spurts of improved output during the period of 1949-1976, Mao's reforms made little progress toward instituting policies which ensured consistent increases in economic growth needed for the long term modernization of the Chinese economy.

Mao's focus on ideology as well as political intervention and control in every facet of economic life hobbled China's economy. The high priority given to heavy industry resulted in the underdevelopment of light manufacturing and the creation of heavy industrial sectors highly dependent on government subsidies. Industrial areas were concentrated in a few areas of the country -- particularly in the northeastern provinces. Centralized planning often led to a mismatch between inputs and outputs as well as overly optimistic targets resulting in low quality goods. Mao's purges of economists, educators, managers, and cultural elite seriously eroded confidence in Mao's techniques and resulted in the untold loss of educated people. The limitations on foreign trade resulted in low technological innovation and growth. The creation of an "iron rice bowl" industrial base welded people to jobs for life regardless of ability and, eventually, subsidized low productivity growth. Most importantly, Mao placed communist ideology ahead of economic modernization and sought to ensure that the people of China would embrace his interpretation of communist values and his set of priorities.

Twenty-seven years of Mao Tse-tung's economic policies (1949-1976) left an indelible mark on China's ability to modernize. Probably no one in China understood Mao's political economic legacy better than Deng Xiaoping. He lived through the Long March and participated in Mao's communist takeover of China. Deng Xiaoping also played varying roles in all of Mao's reforms as either a

government official, a "Capitalist Roader" exile, or a rehabilitated government official. During this time, Deng Xiaoping pushed a philosophy of economic reform that Mao consistently rejected. By the time that Deng Xiaoping became Vice Premier of China, his Four Modernizations and its underlying philosophy were fully developed. The 3rd Plenary Session of the 11th Central Committee of the National Party approved the Four Modernizations in December, 1978.

Under Deng Xiaoping's leadership, the primary national security objective shifted from traditional communist themes to the modernization of agriculture, industry, science and technology, and national defense. The aim of the Four Modernizations was and still is to "turn the country into a relatively advanced industrialized nation by the year 2000."

In Deng's view, foreign investment and technology were needed to move China's industrial base into the 21st century. Initially, the money received from the sales of exported raw materials and agricultural products would finance the imports of equipment, technology and management expertise needed to develop and expand light manufacturing and other export producing industries. The products of these enterprises would fuel more and different exports which would lead to economic growth and industrial modernization and which provide the hard currency needed to buy international goods. Eventually, all Chinese would benefit from an increased standard of living and China would secure a position in the

international community to influence world events.

Deng Xiaoping's fundamental strategy to accomplish the opening of China to international trade and investment was to take gradual, incremental steps which would resemble "groping for stones to cross the river". Many small steps would be taken and those that were successful would be the basis for further, expanded implementation.

EVALUATION OF SEZ PERFORMANCE

Special Economic Zones began as a small step with limited objectives. Their original purpose was to serve as a potential economic policy alternative to attract foreign investment into China which would provide the seed money and technology to modernize China's economy. These four Special Export Zones would "open up a window to the outside world -- a window of technology, a window of knowledge and a window of management."³

Although the goals for the SEZs have expanded and changed over time, there are three objectives which have remained relatively consistent since the initial establishment of the original four Special Economic Zones in 1979.

1. Develop the coastal area of China through experimental, controlled enclaves.
2. Attract and exploit foreign investment to modernize China's economy.
3. Provide a window to the outside world -- window to technology, knowledge and management.

These three objectives represent the "core" expectations and,

as such, are the three criteria that are used to evaluate the performance of the original four Special Economic Zones.

**CRITERION 1: DEVELOP THE COASTAL AREA OF CHINA THROUGH
EXPERIMENTAL, CONTROLLED ENCLAVES.**

The initial development of the Special Economic Zones reflected the export processing zones and free trade zones that China's officials and economists had visited and studied. Government authority to pursue a "special export zone" entity was introduced in 1978. Chinese central government document "Number 38" recommended developing an "integrated export commodity production complex, an attractive resort for Hong Kong and Macao tourists and a modern frontier town within a certain (unspecified) number of years."⁴ Local officials from two of China's coastal provinces, Fujian and Guangdong, responded to Number 38 with specific proposals.

Official government approval to practice "special foreign economic policies" and to experiment with "special export zones" was given in July, 1979 for four zones -- Shenzhen, Zhuhai, Xiamen and Shantou.

Each of the four zones selected was located on the southeastern coast of China, in close proximity to the established trading and financial centers of Hong Kong, Macao and Taiwan. The original sites for the zones were small, undeveloped areas easily

separated from the rest of China. A fence was actually completed around the Shenzhen zone in 1984. However, the requirement for a physical boundary around the perimeter of the remaining three SEZs was dropped due to the cost of their operation and maintenance.

Site criteria, labor availability, infrastructure adequacy, rules and regulations were all established at a later date. Initially, there was not a centrally planned, economic blueprint for Special Economic Zones nor is there one today. Even the name of the zones changed. In May, 1980 the term "special export zones" was changed to "special economic zones" to reflect their connection to other parts of China's economy and to the broad range of activities that the Special Economic Zones could undertake to encourage foreign investment and economic growth.

The SEZs began to show signs of economic progress during the mid 1980s. The Shenzhen SEZ in Guangdong took an early lead over the other SEZs in terms of growth in population, industrial contracts, foreign investment, number of enterprises, and international trade. Population for Shenzhen almost doubled from 69,645 in 1978 to 128,616 in 1982. The number of industrial contracts signed with foreign participation grew steadily from 112 in 1979 to 714 in 1983.⁵ More importantly, the percentage of foreign investment coming into the Shenzhen SEZ's industrial sector grew from approximately 10 percent in 1980 to 44% in 1983.⁶ This was a positive indication that foreign investors' initial interest in the Shenzhen SEZ's real estate market and tourist industry had

shifted to the development of production capacity.

The growth of Shenzhen's electronics industry is an example of the direction and growth of this trend.

Figure 1

The Development of the Electronics Industry in Shenzhen⁷

| | <u>1978</u> | <u>1982</u> | <u>1983</u> |
|--------------------------------------|-------------|-------------|-------------|
| Establishments (no.) | 1 | 12 | 60 |
| Employment | 300 | 4,700 | 15,000 |
| Floor area (sq m) | 1,000 | 110,000 | 280,000 |
| Gross output value (million yuan) | 700 | n/a | 320,000 |

Deng Xiaoping toured Shenzhen, Zhuhai, and Xiamen SEZs in 1984 and was impressed with what he saw. He interpreted the early success of the SEZs as confirmation of the legitimacy of the special economic zone concept as well as the correctness of associated domestic economic reform decisions designed to encourage foreign investment and free market enterprise. Deng Xiaoping's response to SEZs progress was to improve and expand SEZ policy and sites.

The new policies were aimed at "enticing outsiders and building relations with locals." These policies addressed SEZ issues concerning "cutting down on red tape, improving the physical infrastructure and offering new ingredients in the incentive

package."⁸

In addition to making China's SEZs more attractive to foreigners, the government approved the expansion of zone policy. By spring of 1984, the Central Committee and the State Council jointly issued recommendations that marked the beginning of actual zone-like development on Hainan Island."⁹ Beijing also announced the implementation of certain Special Economic Zone policies in fourteen additional cities as well. These fourteen cities were not given the complete Special Economic Zone status of the original four zones -- but they did create a series of smaller Special Economic Zone like enclaves along the coast of China from Dalian in the north to Beihai in the south.¹⁰

During the second annual Open Coastal Cities and Special Economic Zone Conference which was held in Beijing from January 25 - January 31, 1985, the Pearl River and Yangzi deltas were opened along with a triangle in southern Fujian composed of Xiamen, Zhangzhou, Quanzhou.

In addition, to the numerical growth of Special Economic Zones, the original SEZs were allowed to expand in land area.

Figure 2

SEZ Land Area Comparison

| | Original | Current |
|---------|-----------------------------------|----------------|
| | <u>(square kilometers)</u> | |
| Shenzen | 327.5 | 1693.0 |
| Zhuhai | 6.8 | 15.6 |

| | | |
|---------|-----|--------|
| Xiamen | 2.5 | 1500.0 |
| Shantou | 1.6 | 52.6 |

Even with the approved expansion, the SEZs retained their original characteristic of small controlled enclaves. The three SEZs in Guangdong accounted for about .8% of Guangdong which has a total land area of 220,000 square kilometers. Xiamen is about 1.2% of the 123,000 square kilometers in Fujian.

The euphoria of SEZs' growth in 1983/1984 and Deng Xiaoping's successful visit was short lived. By 1985, Beijing faced a growing inflation problem and increasing evidence of serious corruption problems in the SEZs. However, neither Beijing's recessionary policies nor bureaucratic and media attacks on the "spiritual pollution" of the SEZs seriously changed SEZ business practices or economic reform progress.

By the end of the 1980s, the province of Guangdong had transformed itself from a backwater, predominately agrarian area to a metropolis where free enterprise flourished. The story for the Xiamen SEZ in Fujian province mirrored Guangdong's transformation. "As recently as 1985, one westerner recalls, Xiamen was a dead city, with one western owned factory and no street lights. Not now. Its industrial output has increased sevenfold since 1980. Exports last year were 21% higher than in 1989."¹¹

There is no doubt that the success of the original four SEZs contributed significantly to the development of the coastal area of China. As the following figure demonstrates, the economic

revitalization of the coastal area reversed a trend begun in 1949 which focused investment and industrial development in the northeastern and inland provinces.

Figure 3

Gross Value of Industrial Output by Region¹²
(constant 1952 yuan in millions)

| <u>Region</u> | <u>1952</u> | <u>1983</u> | <u>% Growth</u> |
|----------------|-------------|-------------|-----------------|
| Northeast | 6814 | 97,021 | 1324% |
| North | 4838 | 95,970 | 1884% |
| East | 13,901 | 228,442 | 1543% |
| Central/South* | 4694 | 124,598 | 2554% |
| Southwest | 2251 | 49,266 | 2088% |
| Northwest | 1633 | 30,144 | 1746% |

*Includes Guangdong

Figure 3 also underscores the fact that the economy of every region in China grew during the period 1952 to 1983 with the two regions in southern China growing most rapidly. This is still the case today. One of the reasons for continuing high growth rates in Guangdong province is the ability of provincial and local government officials and entrepreneurs to capitalize on zone policies. This practice evolved slowly as the three SEZs exported their brand of market economics beyond their established borders into outlying localities due to the economic interdependencies of

regional sources of labor and resources. In other cases, local officials set up retail outlets outside of the SEZs specifically to encourage trade with the interior. The current philosophy of businessmen in Guangdong is to "decide what helps the productive forces, what will improve the people's standard of living. Then just do it."¹³

During the early 1990s, analysts and reporters increasingly referred to the provinces of Guangdong and Fujian rather than specifically to the SEZs as centers of economic dynamism and capitalist growth. This is a subtle, but important distinction which indicates that local people -- outside of the SEZs -- have embraced economic liberalization. Deng Xiaoping appeared to endorse Guangdong's expanded, provincial model during his January 1992 trip to the province. At this time, Deng Xiaoping challenged Guangdong to "become Asia's fifth dragon -- by reaching the economic level of nearby capitalist Hong Kong, Taiwan, Singapore and South Korea -- in the next two decades."¹⁴

Deng's challenge signaled the end of SEZs as limited, controlled enclaves and initiated a wholesale expansion of development zones. "With a green light from the powers that be, all of the provinces, cities, counties, and even villages are stepping up the pace of opening up. News of this or that region establishing a development zone is by now commonplace. According to unofficial statistics, more than 150 development zones were set up during the first four months of this year."¹⁵

If in fact "practice is the sole test of truth", one of the ways that Guangdong will continue to grow and prosper is to ignore, to the greatest extent possible, Beijing's politics and policies. While Beijing gave local SEZ authorities a good deal of autonomy to make decisions and supported SEZ efforts with new regulations and regulation changes to encourage foreign investment, it also restricted the SEZ experiment in many ways.

Beijing did not insulate the Special Economic Zones from national economic policies or party politics. Periods of retrenchment, austerity and revisions as well as central government control on exports and/or imports, and foreign exchange availability all influenced zone performance and the SEZs' ability to attract and sustain foreign investment.

The Special Economic Zones also had to compete with other areas of the country and with state enterprises for natural resources and investment funds needed to improve transportation, energy availability, and new construction. The pace and depth of Beijing's reforms did not match the requirements of the SEZs expansionary plans -- bribery, corruption, and smuggling became "normal" business practices.

All of these factors constrained the amount, direction, speed and profitability of SEZs' experimentation in free market economics. Some analysts identify political issues and policy changes as key reasons for the high costs of doing business in the SEZs. The following statement sums up this perspective:

Structural characteristics of the Chinese state have critically influenced SEZ policies and economics. Political and policy instability are consequences of bureaucratic underdevelopment and ingrained personalism. Internal state incoherence has hampered economic performance as the unsteady regulatory environment has periodically repelled foreign investors. This situation is exacerbated by the problems associated with reforming the excessive scope of state power in the economy. Decentralization and structural reform, while necessary, have pushed SEZ costs higher. In sum, zone problems are rooted in domestic Chinese political economy.¹⁶

The original Special Economic Zones provided a vehicle for the development of China's coastal area. While political and bureaucratic intervention limited the extent of SEZ experimentation, there is no doubt that the SEZs practiced a distinctively "Chinese" version of market economics which resulted in economic growth based on foreign trade and investment.

The experience of the SEZs indicates that more reform is needed to sustain the success of the "provincial" model in the future. Of significant concern is the high level of political involvement in economic decisionmaking and the lack of accompanying structural reforms -- particularly pricing and financial systems -- which would allow a free market structure to work properly. The independent philosophy that currently characterizes the Guangdong and Fujian approach to economics raises the question of whether Beijing is able to exert the appropriate degree of control on the economic activities in the southern area to allow China as a whole to profit from their success.

CRITERION 2: ATTRACTING AND EXPLOITING FOREIGN INVESTMENT TO INCREASE CHINA'S ECONOMIC MODERNIZATION.

There is no question that Special Economic Zones have attracted foreign investment into China. "In ten years, the five SEZs (Hainan is included in these statistics) have attracted a cumulative total of roughly US\$ 4.1 billion in actual foreign investment and exported over US\$ 10 billion worth of products."¹⁷

Figure 4 depicts the level of foreign investment for each of the SEZs for 1987, 1988, and 1989. Each of the SEZs, except for Shantou, experienced increases in actual foreign investment during this three year period. Xiamen's jump in 1989 is due to Taiwan's increased investment.

Figure 4

SEZ Actual Foreign Investment¹⁸ (US dollars/millions)

| <u>Year</u> | <u>Shenzhen</u> | <u>Xiamen</u> | <u>Zhuhai</u> | <u>Shantou</u> |
|-------------|-----------------|---------------|---------------|----------------|
| 1987 | 404 | 58 | 69 | 81 |
| 1988 | 444 | 134 | 218 | 34 |
| 1989 | 458 | 769 | 249 | - |

The SEZs have been more successful at attracting Foreign Investment Enterprises than other areas of China. As Figure 5 indicates, in 1989 almost two-thirds of the total 15,362 Foreign Investment Enterprises (FIEs) in China and about half of

the total commitment value of \$18.9 billion U.S. dollars were located in Guangdong and Fujian.

Figure 5
Foreign Investment by Region¹⁹
(million U.S. dollars)

| <u>Region</u> | <u>Number FIEs</u> | <u>Commitment Value</u> |
|-------------------------|------------------------|-----------------------------|
| Guandong/Fujian | 10,022 | 9,239 |
| Metropolitan Areas | 1,286 | 4,251 |
| Other Coastal Provinces | 2,805 | 3,153 |
| Deep Interior Provinces | 566 | 1,578 |
| Near Inland Provinces | 683 | 724 |

Based on the preceding discussion, it would appear that the goal of attracting foreign investment to increase modernization was an unparalleled success. However, this is not the case. The costs of attracting foreign investment are very high. One of the key costs is the capital investment required to support production.

All of the newly established SEZs needed investment to create the infrastructure necessary to support increased manufacturing and trade. Initially the central government provided most of the investment funds needed to support new or increased manufacturing capacity and the growing population. Demand for construction was high. For example, in 1978 the Shenzhen SEZ had 26 establishments

and 5,000 workers. By 1983, there were 443 establishments and 25,000 workers.²⁰ Over the last eight years, Xiamen which has experienced tremendous growth, cost Beijing a total of 3.7 billion yuan in capital construction costs -- mostly from Chinese sources.

As depicted in the following table, the Shenzhen SEZ received about 2 billion yuan between 1979 and 1983. Infrastructure investment exceeded foreign investment in each year displayed on the table.

Figure 6

Shenzhen SEZ Investment in Infrastructure²¹

(million yuan)

| <u>1979</u> | <u>1980</u> | <u>1981</u> | <u>1982</u> | <u>1983</u> |
|-------------|-------------|-------------|-------------|-------------|
| 49.88 | 124.87 | 270.39 | 632.65 | 885.93 |

Construction funds built innumerable projects in the areas of transportation, factories, hotels, housing and energy. When requirements outstripped Beijing's ability or willingness to pay, local authorities floated bonds or borrowed money. The net result was an increase in debt at both the central and provincial governmental level.

Machinery, equipment, and resources were also imported to establish and support manufacturing operations. As the following table indicates the four SEZs imported 3.7 billion (\$US) in 1987 and exported 2.9 billion (\$US). The imports accounted for

approximately 8 percent of China's total imports (43 billion \$US) and approximately 7 percent of all exports (39 billion \$US).

Figure 7

SEZ Trade Performance in 1987²²

(million U.S. dollars)

| | <u>Shenzhen</u> | <u>Zhuhai</u> | <u>Shantou</u> | <u>Xiamen</u> |
|---------|-----------------|---------------|----------------|---------------|
| Imports | 2,250 | 371 | 542 | 488 |
| Exports | 2,035 | 319 | 279 | 304 |

The data highlight the fact that all of the SEZs ran a trade deficit in 1987 and that their total trade deficit of 714 million (\$US) was almost 20 percent of China's trade deficit of -3.78 billion (\$US). As long as the SEZs (and their associated provinces) are building infrastructure and depending on imported production lines, equipment, equipment spares and products to produce exports -- the total costs of production will exceed the value of exports.

Domestic capital costs, favorable tax incentives and special profit incentives in the SEZs have attracted the foreign investment necessary to modernize the economy relative to the beginning of the reform period. Foreign investment has not, in most cases, been sufficient to move the SEZs beyond assembly and processing plants dependent on cheap, plentiful labor.

In addition, Beijing has not been successful at collecting

taxes in any of the SEZs. "For two years, authorities in the capital have been engaged in bitter fights with provincial leaders over how much money they must give to Beijing. The central government has backed down, deepening its biggest budget deficit ever."²³

The fact that Hong Kong and Taiwan are the source of much of the foreign money invested in Guangdong and Fujian is a serious concern to China's political leadership. "Some 70% of direct foreign investment in the People's Republic of China (PRC) comes from Hong Kong; over the decade 1979-1989 almost 22,000 enterprises with a realized capital of U.S. \$15.4 billion were approved by the Chinese authorities. Most of these investments are relatively small scale operations in the SEZs and Pearl River Delta area of Guangdong province (the home province of most Hong Kong people). They are not only the major source of Hong Kong re-export trade, but are also estimated to employ as many as 2 million industrial workers -- about twice the number working in industries in the territory."²⁴

Taiwan's financial involvement in the SEZs is also noteworthy. "In 1989, according to Taiwanese sources, out of Taiwan's overseas investments of \$3.2 billion, \$2 billion went to the mainland, making Taiwan the largest source of foreign investment in China in 1989. Most of these funds have gone to Fujian and Guangdong provinces and are concentrated in Xiamen, right across the Straits."²⁵

The SEZs attracted foreign investment into China which has increased production capability and international trade. The costs of attracting foreign investment resulted in an unprecedented level of dependence on Hong Kong and Taiwanese investors to develop and sustain SEZ economic progress. The financing of infrastructure costs required to attract foreign investment, the need for imported manufacturing equipment and spares have increased budget deficits at the central and provincial levels. There is mounting concern within China that the amount of credit being pumped into Guangdong and Fujian could trigger uncontrollable inflationary pressures.

CRITERION 3: WINDOW TO THE OUTSIDE WORLD -- TECHNOLOGY, KNOWLEDGE AND MANAGEMENT.

Under Deng Xiaoping's economic reforms, the SEZs were to utilize openness -- "gaige kaifang" -- to improve technology, increase knowledge, and develop management expertise. The following sections assess the level of success that the original four SEZs had in each of these areas.

TECHNOLOGY

The Special Economic Zones have attracted technology into China. At the lower end of the technological spectrum, Chinese are

producing and buying "modern" consumer durables at unprecedented levels. Nowhere is this more apparent than in Guangdong -- "where half of China's mobile telephones are."²⁶ As the following Figure shows, the Chinese have far more consumer durables than ever before.

Figure 8

Average Stocks of Consumer Durables²⁷
(per 100 people)

| <u>Type</u> | <u>1978</u> | <u>1987</u> |
|-----------------|-------------|-------------|
| Sewing Machines | 3.5 | 11.0 |
| Watches | 8.5 | 42.8 |
| Bicycles | 7.7 | 27.1 |
| Radios | 7.8 | 24.1 |
| Television sets | 0.3 | 10.7 |

Joint ventures and wholly owned foreign businesses have supplied modernized machinery and production lines for SEZ factories. These factories produce textiles, toys, and shoes in greater numbers, and of higher quality than ever before. The market for these goods has expanded to the point "where they accounted for a third of China's total exports in 1990."²⁸

While this growth represents a degree of technical progress relative to where Guangdong and China as a whole were in the early 1970's, the SEZs have not met the level of technology transfer envisioned at the beginning of the current reform period. SEZ export growth is based primarily on low wage rates, low real estate costs and low overhead costs. The product mix of SEZ exports is also indicative of developing economies rather than those of

modernized, industrial nations which produce a wide variety of products and achieve production efficiencies through the application of high technology.

Some observers conclude that Chinese managers lack three main ingredients necessary for promoting technological advance: 1) a strategic vision and strong enterprising spirit; 2) the courage to take risks and be a pioneer; and 3) a high level of scientific culture and strong aptitude for management.²⁹

MANAGEMENT

Developing these three qualities in Chinese managers involves significant cultural, political, economic, and educational shifts in attitudes that challenge some deeply held Chinese beliefs. At the base of China's current management philosophy is Mao Tse-tung's legacy which continues to influence economic discussions and decisions in China today.

The basic tenets of the economic portion of the Four Modernizations were overlaid over Mao's emphasis on self sufficiency for China as a nation and individual sacrifice for the state. Mao Tse-tung discouraged individual worker initiative and consumerism, and greatly limited trade. His precepts valued government control of the people as one of the primary means to accomplish government economic plans and shape economic outcomes.

Mao's emphasis on central planning and adherence to party line and values, left very little need for western style management practices. Deng Xiaoping has not replaced Mao's old slogans with many new ones, or reconciled the new philosophy to the old. Deng Xiaoping has changed laws in conjunction with economic reform initiatives to gradually provide managers with alternatives to old approaches. Some individuals seize the initiative and become phenomenally successful entrepreneurs; some resist change; others try to adapt to new management ideas.

Considering this background, it is not surprising that many Chinese managers appear slow to develop the expertise needed to take advantage of market opportunities. Managing and motivating employees are very difficult tasks for "free enterprise" Chinese managers -- especially delegating work, firing employees, and rewarding performance.

There is widespread acceptance in China that more needs to be done in the management arena. The establishment of several management programs jointly run with Chinese partners is an encouraging sign. The educational system is adapting slowly to increasing interest for a Master of Business Administration curriculum. The State Education Commission (SEC) approved MBA programs on a trial basis at nine universities in early 1991.³⁰

KNOWLEDGE

Chinese managers of "free enterprises" are slowly learning how to negotiate, market, and sell ideas and products. Foreign investors in joint and wholly owned foreign enterprises point out that Chinese businessmen need to develop more technical and legal expertise as well as a respect for contractual stipulations and requirements. A major issue concerns the importance and recognition of individual property rights.

Under Mao, "international markets were regarded as economically anarchic systems from which China's domestic economy should be insulated. Accordingly, international trade was monopolized by the state and enterprises were cut off from direct contact with the international economy."³¹ Beijing's decision to allow the SEZs to trade directly with foreign companies exposed SEZ managers to the international market for the first time. For many, it will take time to shift from the China-centered universe of the past to the international perspective required to operate effectively as a truly global participant in the world's marketplace.

The decision to open China to the world also led to increased government participation in international trade-related organizations. China's involvement since 1980 with the World Bank and the International Monetary Fund resulted in economic advice and

capital. The requirements for acceptance into the General Agreement on Tariffs and Trade (GATT) provide opportunities for the Chinese to learn more about acceptable and effective trading practices.

The increasing involvement of all governmental levels and individual Chinese in international trade greatly expands China's knowledge of global markets. It also brings exposure to other cultures, beliefs, and values. Economic success in the global arena is encouraging the examination of widely held ideas. Many Chinese are questioning the role of politics in economic decisionmaking; the correct balance between centralization and decentralization; the degree of foreign influence bought with imports; and the "social" side of free market economics.

Discussions concerning these and other areas expand knowledge and , in some cases, engender dissatisfaction with the current system. Some believe that economic liberalization policies brings renewed hope for ideological liberalization. Ideological liberalization requires relinquishing and reexamining the teachings of Mao. As Deng Xiaoping said, "The "Left" has become a force of habit. Today there are few in China who oppose reform, but when it comes time to formulate and implement concrete policies, a nostalgia for past times is apt to appear and the things of habit emerge to exert their effect."³²

There is an increasing awareness within China that the great success of the decade following the initial introduction of the

Four Modernizations cannot be sustained without an increased emphasis on training and education. Students in unprecedented numbers are attending in foreign schools. Approximately 100,000 students came to the U.S. to study and to do research between the years 1979 and 1990. In 1979 1,330 Chinese students entered the US to study. Today there are more than 13,491.³³

The experience of the original SEZs indicates that the policies associated with "gaige kaifang" improve technology transfer, develop management expertise and increase knowledge. However, the pace of widespread acceptance and absorption of new ideas is slow and difficult. Equally true, is the fact that the central government has no control over what knowledge is acquired and how that knowledge will influence China over the long term.

CONCLUSION

In the early years of reform, the SEZs played a small, but important role in opening China's "Red Door" to the international community and in experimenting with reform initiatives. The high rates of growth, availability of consumer products, increased foreign investment and an improved standard of living drew widespread attention to market economics as a viable alternative to state owned enterprises and central planning. In the process, Guangdong and Fujian became national and international symbols of capitalism with "Chinese characteristics" and of Deng Xiaoping's

successful leadership of economic reform.

Some believe that "the basic framework of mainland China's national development plan is now in place."³⁴ From a western perspective, this would appear to be a logical conclusion. Our faith in free market economics is based on over two centuries of experience and incredible success. However, the Chinese view free market economics from an entirely different perspective.

There is not a consensus within the central government on the utility of market economics to promote Chinese values, political system, and cultural beliefs. The ability of the SEZs to survive and flourish beyond the boundaries of the original SEZs despite intense ideological criticism within China and widespread recognition of SEZ shortcomings is due predominantly to Deng Xiaoping's private and public support for the SEZs. His well publicized trip to the SEZs in 1984 and in 1992 gave tremendous credibility to reform efforts, stifled the voices of dissenters and brought international attention to the area.

The future expansion of free market activities as practiced in Guangdong and Fujian depends on the support of Deng Xiaoping who is now 88 years old. This political reality could create a serious problem for the future of economic modernization when Deng Xiaoping dies. Without his strong political leadership, party hardliners may be tempted to roll back reform initiatives or disrupt the forward momentum of SEZ progress.

While the single most important factor in determining whether

or not the SEZ concept evolves into a national model is Deng Xiaoping's successor, there are other significant challenges to overcome as well. The SEZs opened the way for the expansion of the coastal region of China to free market initiatives which resulted in economic growth that is unsurpassed by any other country in the world today. Hand in hand with increased economic growth is an unprecedented level of mainland Chinese dependency on Hong Kong and Taiwan for investment, management expertise, and knowledge about financial and international markets. The expanding integration of the "Greater China" area, the influence of ethnic Chinese who invest in China but live outside China, and the growing dependency on other nations for materials, products, and investment threaten the Chinese concepts of self-sufficiency and sovereignty.

The emergence of the "Greater China" phenomenon and international interdependencies expose China's economy to the vicissitudes of international economic cycles and create pressures to ensure stability at home. The need for stability at home constrains the central government's options in dealing with a host of problems in the economic, political, military, foreign policy and social spheres. This growing web of interrelationships is an unintended consequence of an economic reform strategy based on China's desire to exploit foreign trade to modernize and gain a position of respect and influence in the world. It remains to be seen if the Chinese are willing to accept the constraints of international involvement as a necessary cost of industrial

modernization.

Many doubt that economic reform has deepened sufficiently to support widespread implementation of the Guangdong and Fujian "provincial" market economic model throughout China. There are serious deficiencies in China's financial, banking, foreign exchange, accounting and tax collection systems which prevent the government from maintaining stable economic conditions through the appropriate use of a variety of economic tools.

The central government's policies of decentralization of fiscal and economic decisionmaking to Guangdong and Fujian without developing integrated, politically neutral economic policies, financial systems, and meaningful, accurate statistics for assessing performance worked during the early years of economic modernization when the SEZs were few in number and small, controllable enclaves. The expansion of the SEZ concept throughout China without implementing appropriate tools to control inflation and to ensure equitable tax policies invites social and economic chaos.

There is also a question as to whether the central government can afford the costs of significant expansionary efforts in the central and western provinces. More and more local and provincial governments want to emulate Guangdong and Fujian's successes to improve their standard of living -- despite the fact that in many central and western provinces there are serious deficiencies in energy availability, transportation, buildings, and skilled labor.

All of these factors add pressure to the expenditure side of the central government's budget and increase the likelihood of larger and larger budget deficits -- even if revenue growth continues to grow.

A variety of statistical sources agree (this does not happen often) that the central government, Guangdong and Fujian ran continuous and growing budget deficits since 1979.³⁵ If Guangdong and Fujian are typical examples, the costs of administration, construction and services will increase along with industrial output. The cost of administrative activities in the SEZs parallels the expanding power of local political party members who shape local decisions and grant favors -- despite a steep decline in the central communist party's influence on the provinces.

Expansion of the SEZ concept throughout China means converting state owned enterprises into free enterprises. Beijing has recently taken the first of many needed steps toward their conversion. The demise of the state owned enterprises which still account for approximately 53 percent of the national output would signal a break with past governmental policies and promises. Aside from disrupting a steady source of income for the central government, the disestablishment of state owned enterprises would break the "iron rice bowl" and with it the social security safety net of millions of Chinese who believed that loyalty to Mao Tse-tung and the communist party would ensure job security, health benefits and housing for life.

Deng Xiaoping superimposed his Four Modernizations over Mao Tse-tung's teachings and beliefs which emphasized communism as a way of life -- individual sacrifice for the state and communist party control of the people. Under Deng Xiaoping's reform efforts, the goal of building a world class country by the 21st century was the highest priority; building a communist state was relegated to second place. Systemic problems arise from the fact that the Four Modernizations do not provide a set of core values which integrate the political, military, economic and social fabric of Chinese life.

Pushing to fill the "values" vacuum are the influx of new ideas from ethnic Chinese who live outside of China, the exposure of many Chinese to the outside world through communications and international trade, and the return of large numbers of Chinese students from foreign universities. The tensions which result from the friction of conflicting values can lead to social alienation, fragmentation and unrest. Social instability may refocus China's priorities away from the expansion of economic modernization.

The legitimacy of Deng Xiaoping's leadership is the substance of national cohesion in China today. Deng Xiaoping will continue to lead his evolutionary modernization effort through gradual implementation policies and laws that provide incentives for change and individual opportunities for an improved standard of living.

Coming to terms with the enormous economic, political and social costs required to foster continued modernization efforts and

the long term implications of successful, country-wide expansion of SEZ concepts will be Deng Xiaoping's legacy to the leaders who replace him. Deng Xiaoping institutionalized his vision of China's economic potential with the achievements of the SEZs. Whether the SEZ concept will continue to grow from a "provincial" SEZ model to a national model depends on how China's leadership meets the significant challenges of the next several decades.

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